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COMPANY LAW AND THE PROTECTION OF CREDITORS' INTERESTS:

FROM CAPITAL MAINTENANCE TO SOLVENCY AND LIQUIDITY AND BEYOND - A SOUTH AFRICAN PERSPECTIVE

Research dissertation / research paper presented for the approval of Senate in fulfilment of part of the requirements for the M. Phil (Commercial Law) degree in approved courses and a minor dissertation / research paper. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of M. Phil (Commercial Law) degree dissertations / research papers, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation / research paper conforms to those regulations.

Signed by candidate

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1 INTRODUCTION

Company law in South Africa has recently been subject to an extensive review which culminated in the passing of a new act, being the Companies Act No. 71 of 2008 (hereinafter 'the new companies Act or 'new Act'). The new Act has not yet come into effect but officials at the Companies and Intellectual Property Office remain optimistic that the new legislation will become effective before the end of the year.[1] The new Act takes South African company law away from its English law roots and brings it into line with international trends. Indeed the South Africanisation of company law was one of the stated objectives of the review process; it being held to be important that the unique characteristics of the South African context and especially the promotion of equity as envisaged under the Constitution[2] be taken into account in the drafting our laws.[3]

This research paper is primarily concerned with the legislature's efforts to protect company creditors' interests via mechanisms designed to maintain the economic or capital base of a company.[4] Historically this found expression in the capital maintenance rule but problems with this rule resulted in it being shelved in favour of a regime based on solvency and liquidity. The concept of imposing solvency and liquidity requirements on companies in certain instances was introduced into South African company law in amendments to the existing Companies Act[5] promulgated in 1999.[6] This resulted in the fragmented approach to the maintenance of an economic or capital base of a company that we currently face: certain areas being subject to the newly imposed solvency and

[1] There have been many media reports concerning problems with the new Act and the regulations thereto. For an example of such see 'Companies Act a Mess' by Ann Crotty in Business Report of 1 February 2010. The Department of Trade and Industry acknowledged that there are matters that require attention prior to the commencement of the new Act and published the draft Companies Act Amendment Bill, 2010 on 19 July 2010. It is anticipated that Parliamentary hearing on the new bill will commence in September and it is therefore unlikely that the official target date of 1 October will be met. This despite a notice dated 21 July 2010 issued by the Companies and Intellectual Properties Registrations Office confirming that the target date for commencement remains unaltered. This paper does not address the changes proposed in the draft Companies Act Amendment Bill, 2010.
[2] Act 108 of 1996.
[3] Department of Trade and Industry, South African company law for the 21st century: guidelines for corporate law reform GG 26493 of 23 June 2004 at para 2.2.2.
[4] The term 'capital' is used here in a generic sense.
[5] Companies Act No. 61 of 1973 hereinafter 'the existing Companies Act' or 'existing Act'.
[6] Companies Amendment Act No. 37 of 1999 hereinafter 'the amendment Act'.

liquidity requirements while at the same time other provisions built around capital maintenance remaining in force.

The process of company law review continued in the vein of solvency and liquidity and the approach adopted under the new companies Act represents a coherent and consistent application of this new standard.

This discourse begins with a consideration of the purpose of company law in general, and then more specifically in relation to the protection of creditors' interests. This is dealt with in parts 2 and 3.

Once the approach to the protection of creditors' interests has been critically considered, the general importance of the company remaining economically focused and the evolution of the capital maintenance doctrine as the legal means of achieving that end is investigated. Part 4 entails an examination of the capital maintenance rule, its origins and purpose and how this was historically incorporated into our law. It ends by identifying problems with capital maintenance rules.

Part 5 introduces the concept of solvency and liquidity requirement as an answer to maintaining the economic viability of companies and addressing the deficiencies of the capital maintenance doctrine. It reviews the bold approach adopted by the United States in being the first to depart from the capital maintenance doctrine in the 1980's and the commonwealth jurisdictions that followed suit. The United Kingdom's persistence with capital maintenance is also discussed.

Part 6 deals with the amendments to the existing companies Act promulgated in 1999 that signalled our departure from the capital maintenance doctrine and the resultant inconsistencies in the law as it currently stands.

Part 7 moves on to examine the coming company law dispensation in relation to the protection of creditors' interests. The comprehensive solvency and liquidity approach adopted by the new companies Act is discussed and evaluated in light of our constitutional framework

2 THE PURPOSE OF COMPANY LAW

How one views the purpose of company law will depend upon how one views the essence and purpose of the corporate form.[7] Legal theory, legal doctrine and social policy join in a continuum that facilitates different viewpoints in the hands of those with predetermined policy agendas at different times. Law is a normative social practice and these tenets are the building blocks of a company law world view that have been rearranged by scholars and commentators over the course of modern history to suit the prevailing mood in society.

Million explains that a discussion of company law is usually viewed as consisting of at least three dimensions.[8] Firstly there is the aspect of the company being viewed as a real and distinct entity as opposed to it being regarded an aggregation of members' interests. Secondly there is the need to distinguish between the company as an artificial creation of law on the one hand and a natural creation of private initiative on the other. Thirdly there is the debate to be had concerning whether company law is exclusively private in nature or whether it has a public element to it. Whether formally acknowledged or not, it is one's approach these underlying questions that ultimately determine what one's view of the purpose of a company is and as a result how one views the purpose of company law. It has been said that one's view on the purpose of the corporate form amounts to nothing more than an ideological belief and that the purpose of corporate law may therefore be whatever you wish it to be.[9]

This is no doubt true within limits and while it is enlightening to consider the metaphysical underpinnings of the theories of corporate personality and how they affect one's view of corporate law, for present purposes the discussion about the purpose of corporate law must be approached from a more practical viewpoint.

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[7] The terms company law and corporate law will be used interchangeably.
[8] Millon, D 'Theories of the corporation' (1990) 2*Duke Law Journal* 201 at 201.
[9] Green, CH 'The purpose of a company is....' Trust Matters, Trusted Advisor Associates LLC internet article posted on 1 March 2010. Available at http://trustedadvisor.com/trustmatters/753/The-Purpose-of-a-Company-Is [accessed on 17 August 2010].

Pragmatically, Mongalo states that the purpose of company law may be seen as making the corporate form available for primarily two purposes, the first being capital raising and its associated functions of corporate finance; and the second being to regulate those whose power stems from the use of the capital so raised, that is corporate governance.[10] In this paper it is the latter purpose of the corporate form that we are concerned with and hence will we view the purpose of company law as a means of the regulation of company power.

As a juristic person the company cannot act for itself and requires the intervention of natural persons. Agents of the company therefore wield the company's power and the company is vulnerable to such agents' actions. Directors and officers are the natural person agents tasked with carrying out the acts of the company and employing its capital.[11] It is well established that directors' duties are twofold: fiduciary duties and the duty of care and skill and that these duties are owed to the company itself. For our purposes, we will concentrate on the fiduciary aspect.

Fiduciary duties may be broken down into component duties as follows: there is the duty not to exceed powers, the duty to exercise powers for a proper purpose, the duty to exercise independent and unfettered discretion, the duty not to put oneself in a position where one's personal interest is at conflict with the companies interest, the duty to deal with the company in good faith, the duty not to make secret profits, the duty not to usurp corporate opportunities, the duty not to compete with the company and the duty not to misuse confidential information.[12]

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[10] Mongalo, T *Corporate law and corporate governance* (2003) Van Schaik Publishers, Gauteng at 151.

[11] The term directors' duties will be used to refer to both directors' and officers' duties.

[12] Blackman, M et al *Commentary on the Companies Act* (2002) at 8-39.

This paper is concerned with the duty of directors to the use their powers for a proper purpose and more specifically to exercise their powers of discretion bona fide in the interests of the company as a whole. Blackman et al explain that this test for directors' actions is subjective as to means but objective as to ends.[13] Business judgment enters into the first part of the test but the interests of the company are as understood in law. In law the interests of the company have been held to be the interests of the general body of shareholders.[14] This has been criticized on the basis that as a separate legal entity the company's interests should not merely be interpreted to be the interests if shareholders. The fact that the courts have interpreted the interests of the company narrowly in this manner is as a result of the evolution of the modern company from deed of settlement companies in England in the 1800s. Deed of settlement companies were viewed as nothing more than an aggregation of members' interests and directors were consequently viewed as nothing more than agents for shareholders. In subsequently interpreting general incorporation statutes, the courts did not give adequate weight to the significance of the separate legal personality of the company bought about by these enabling statutes and instead persevered with the formulation of directors' duties as previously adopted. [15] This coupled with the view that as an artificial entity a company can have no independent interests other than of those who are interested in it has resulted in the modern understanding that the shareholders interests are the relevant interests to be considered in the company context.[16] I will question the validity of this understanding in part 7.

The discussion thus far may be summarized as follows: The purpose of company law may be viewed philosophically or pragmatically. One of the purposes of company law from a pragmatic viewpoint is the regulation of the power that directors have over the company and its assets. In order to guard their loyalty directors are subjected to among others fiduciary duties. It is settled in our law that directors owe their duties to the company itself and part of the

[13] *Ibid* at 8-62.
[14] *Ibid* at 8-67.
[15] *Ibid* at 8-69.
[16] *Ibid.*

content of fiduciary duties is to act in the best interest of the company as understood in law. Courts have up until now not recognized the company as having any ascertainable interests and have imputed shareholders' interests as the interests of the company. Shareholders' interest are traditionally measured in monetary terms as being the value of the company,[17] often reduced to the share price in the case of listed companies.

Pragmatically then, one of the purposes of company law is traditionally understood to be regulating the actions of directors such that they manage companies in a manner that maximizes the value of the company for shareholders. But should directors ever be required to manage companies in any other group's interest?

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[17] Dodd, EM 'For whom are corporate managers trustees? (1932) 45 *Harvard Law Review* 1145 at 1146.

3 THE COMPANY LAW RESPONSE TO THE PROTECTION OF CREDITORS INTERESTS

3.1 The traditional approach to creditors' interests

The traditional view is that there is no fiduciary relationship between directors and creditors; directors are required to use their powers exclusively to the benefit of shareholders and creditors must largely fend for themselves.[18] There is a however a line of cases that assert that directors may in certain instances, put aside the interests of shareholders in favour of the interests of creditors, these cases will be further examined below. The origin and significance of this trend is as a result of one of the most attractive attributes of the corporate form from a shareholder's point of view, that is, limited liability.

Around the time that general incorporation statutes were being considered in England, during the first half of the nineteenth century, there was a heated debated around the issue of limited liability.[19] While we know that those in favour of making the corporate form and limited liability readily available prevailed, there was nevertheless widespread concern about resultant abuses of making limited liability for incorporators so freely accessible. Initially the types of corporations that were formed had a substantial number of shareholders and undertook projects that entailed infrastructure development, so the argument that private investors would not be prepared to engage in such activities without the benefit of limited liability was compelling and won the day.[20] Whatever the intention of the legislature might have been in promulgating a general incorporation statute, the ambit of the statute was never limited to public corporations and by the dawn of the twentieth century the right of incorporators of private companies to limited liability had been firmly

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[18] Cillers and Benade et al *Corporate Law* 3ed (2000) at 162.
[19] Ziegel, JS 'Creditors as corporate stakeholders: the quiet revolution – an Anglo-Canadian perspective' (1993) 43 *University of Toronto Law Journal* 511 at 512.
[20] Ziegel, JS 'Is incorporation (with limited liability) too easily available' (1990) 31 *Les Cahiers de Droit* 1075 at 1078.

entrenched and was accepted in commonwealth jurisdictions. The corporate veil had thus descended by this time and would not easily be pierced. Shareholders could now even become secured creditors of their own company. [21]

Commonwealth legislatures and the courts are not blind to the potential for abuse and have historically attempted to safeguards the interest of creditors in various ways. Companies were required to advertise the fact that its shareholders enjoyed limited liability by the addition of an appropriate suffix denoting that fact to its name; companies were subjected to rules concerning the raising and maintenance of share capital; companies were required to file certain key information such as their constitution and details of directors and shareholder as a matter of public record; and public corporations were even required to file financial statements. In addition to these measures, the doctrine of *ultra vires* was developed to limit a company's operations to activities furthering only those objects specified in its constitution; and the courts developed a duty of care and skill for directors.[22] Apart from the detailed review of the rules relating to the maintenance of share capital and its related problems that is undertaken below, suffice it to say that in practice these measures proved ineffective and insufficient to protect creditors' interests.

The only really substantial response to the protection of creditors' interest in South African was the inclusion of a section that deals with what is known as reckless trading. This takes the form of section 424 in the existing companies Act. This section represents an overlap of company law and insolvency law. It gives, among others, creditors standing to approach the court to seek relief and gives the court wide discretion to hold company directors and any other persons party to reckless (or fraudulent) trading personally liable for the debts of the

[21] Ziegel *Supra* note 19 at 514.
[22] *Ibid* at 513.

company. Given the lack of an express preclusion and the use of the words 'or otherwise', some have suggested that the application of this section cannot be reasonably restricted only to situations of insolvency and must also therefore operate while a company is still continuing as a going concern.[23] There is however a Supreme Court of Appeal judgment supporting a restrictive approach to the application of the equivalent section in the Close Corporation Act No. 69 of 1984, meaning that creditors are unable to pursue an action in terms of section 424 unless the company is insolvent and consequently unable to meet creditors' claims.[24] This would then appear to be the settled position. There are also contrary views on who a court may determine the beneficiary of the payment to be, however it would seem that even when an action is brought by a particular creditor, as the object of the section is not to alter the priority of creditors and hence favour some creditors (even the particular creditor brining the action), the payment must be made to the company itself for the benefit of all creditors.[25]

Section 424 is a burdensome provision for those found to be acting recklessly or fraudulently and gives the court wide powers to remedy the conduct complained of. While it no doubt has a sobering effect on directors, the utility to creditors is in practice reduced by the fact that a creditor is unlikely to bring an action at own expense, when the benefit to be had will be for all creditors. This would be true even if the section was applied to solvent companies. This means that proactive application to court, even if permitted, would not be attractive to a creditor. In practice the section is only invoked in a reactionary fashion by the liquidator on behalf of all creditors, by which time the financial position of the company is such that all creditors will most likely lose a substantial portion of their claim. Given these difficulties it is therefore worth

[23] Blackman, M et al *Commentary on the Companies Act* (2002) at 14-525 - 26.
[24] *L & P Plant Hire BK en Andere v Bosch en Andere* 2002 (2) SA 662 (SCA) 662.
[25] Blackman et al *op cit* at 14-550. This would also be the case when an action is brought by a liquidator for the benefit of all creditors.

exploring other means by which company law may be proactively employed to protect creditors' interests.[26]

Apart from the reckless trading provision, the traditional lackadaisical response to the protection of creditors seems to stem from a belief that creditors do not require protection because they are able to contractually protect themselves. While this may be partly true for sophisticated voluntary creditors, such logic is wholly inappropriate to apply to all creditors. Even sophisticated voluntary creditors may not be able to adequately protect themselves owing to imperfections in the market for corporate credit. Armour sees such imperfections as relating to among others, unequal bargaining power, informational asymmetries and the fact that real contracts are incomplete.[27]

At this point it will be useful to further understand who is included in the term 'creditors', and that this group is far from homogenous.

3.2 Who are creditors and what are their interests?

The term 'creditor' can be applied to any person to whom a company has a financial obligation, whosoever arising.[28] That is to say that the term applies equally to suppliers of goods and services; bondholders, banks and other lending institutions (providers of both short term and long term finance); taxation authorities and even employees to the extent that their remuneration has not yet been paid. Obviously creditors have an interest in the company fulfilling its financial obligations toward them *qua* creditors. This is what I will refer to as the primary financial interests of creditors.

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[26] This paper does not consider the role of business rescue provisions as a possible means of protecting the interests of creditors.
[27] Armour, J 'Share capital and creditor protection: efficient rules for a modern company law' (2000) 63 *Modern Law review* 355 at 358.
[28] *MacMaster's Trustees v Executor of Kruger* 4 Searle 210.

Beyond the immediately obvious, creditors have an interest in the continued financial health and well-being of a company in its capacity as an active participant in the economy. Suppliers certainly want their invoices to be settled come month end, but they also have an interest in the company continuing to exist into the future in order to consume further goods and services from them and thus contribute to their financial sustainability. Bondholders, banks and other lending institutions require the company to service and settle its debts, but beyond any immediate given debt, such parties also have an interest in the company continuing to borrow from them in the future to give them an opportunity to employ their working capital and ensure their sustainability. The taxation authorities expect the company pay to its taxes levied based upon the trade that it has done in any fiscal year, but the fiscus is dependent upon the continued trading of the company to generate further taxes to fill its coffers and finance the government in the future, thereby ensuring the sustainability of society. Employees want their salaries and wages to be paid timeously but equally important they have an interest in the company being able to continue their employment in the future so that they are able to sustain themselves and their families. And so it goes; thus demonstrating that many different groups of creditors have an interest in the continued financial health and well-being of a company as a financial building block of the economy beyond the immediate satisfaction of the amounts due to them. This is what I will refer to as the secondary financial interests of creditors. As the interests of creditors are diverse, they are not easily grouped or meaningfully catergorised beyond classification as either secured or unsecured.[29]

[29] A further worthwhile distinction is between creditors who choose to become so of their own volition, as opposed to those who become so out of circumstance beyond their control, for example the beneficiaries of a law suit, also known as involuntary creditors.

Unfortunately it is only ever the primary financial interest of creditors that seem to be seriously considered. Let us now consider what the courts have had to say regarding the interests of creditors.

3.3 The problem with Commonwealth cases concerning the protection of creditors' interests

While there have been a number of Commonwealth cases that have touched on the duty of directors to act in the interests of creditors, the judgments in this regard have been inconsistent and have not authoritatively settled the matter. In fact since the matter has been subjected to scrutiny only more questions have been raised.

The end to the passive approach to creditors' interests was signalled in the 1976 Australian judgment in *Walker v Wimborne*.[30] In this case Mason J is famously quoted as saying that, '... directors of a company in discharging their duty to the company must take into account the interests of it shareholders and its creditors.' [31]

Judges in the Commonwealth used this seminal judgment as a licence to further consider the duties of directors to creditors and a host of cases have followed.[32] The rationale for the duty is sound when the company is insolvent (yet certain judgments have suggested that the duty arises even before the company is insolvent)[33] but no court has been able to define what insolvency in this context means.[34]

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[30] (1976) 137 C.L.R. 1 (H. Ct.)
[31] Keay, A 'Directors taking into account creditors' interests' (2003) 24 Company Lawyer 300 at 301.
[32] See Keay *ibid* and Ziegel *supra* (note 19) for a review of these judgements.
[33] See Keay ibid at 302 for a brief discussion on trigger points of insolvency.
[34] McKenzie-Skene, DW 'Directors' duty to creditors of a financially distressed company: a perspective from across the pond' (2006-2007) 1 *Journal of Business and Technology Law* 499 at 509.

Therefore, although the existence of the duty of directors to creditors has now been well established in common law, the scope and exact nature of the duty remain unclear.

The main points of contention are to whom the duty is owed, present or future creditors; when the duty arises given that the state of insolvency is a nebulous and subjective condition;[35] and whether the duty is owed directly to creditors or indirectly as a subset of the interests of the company. There is also a problem in defining the duty given the fact that creditors do not constitute an homogenous group as mentioned above.

In the United Kingdom's review of company law the Company Law Review Steering Group there favoured the inclusion of a directors' duty to creditors in the general codification of directors' duties that was being undertaken. The government however rejected this approach on the unconvincing basis that doing so would influence directors in a manner that would not be conducive to the rescue culture that it was attempting to foster.[36] It instead opted for the vague provision contained in s 172(3) of the Companies Act 2006 and allowing the common law to develop without further statutory guidance. This approach has been criticised.[37]

While the duty to creditors undoubtedly exists in common law, its content remains imprecise. The predominant view in South Africa seems to be that it is an indirect duty that stems from the duty to act in the best interests of the company[38], that it does not exist independently of insolvency and only applies to existing creditors and not future creditors.

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[35] Insolvency is a vague concept. See Grantham, R 'The judicial extension of directors' duties to creditors' 1991 *Journal of Business Law* 1 at 15 who quotes Sealy concerning the difficulty in attempting to formulate a duty that varies with profitability.
[36] Keay *supra* (note 29) at 306.
[37] McKenzie-Skene supra (note 32) at 521 and Keay *op cit.*
[38] Pretorius, JT et al *Hahlo's South African company law through the cases* 6ed (1999) at 286 -87.

[39] This formulation does not materially further the interests of creditors, most significantly, because they do not have standing to bring an action directly against offending directors and as Sealy states ' [a] supposed legal duty which is not matched with a remedy is nonsense.'[40]

3.4 The consideration of risk in the company law response to the interests of creditors

Every business enterprise faces risk. Risk is an unavoidable consequence of being in business and it can never be completely eliminated. The existence of the limited liability company may be seen as means of facilitating such risk taking and enabling projects to be undertaken that would otherwise never see the light of day. In recognition of the fact that the assumption of risk is part and parcel of the director's role, Sealy makes the point that the assumption of such risk is incompatible with a duty of care towards creditors.[41] It would seem that this fact underpins the reluctance on the part of the courts to impose duties in favour of creditors on directors and validates the United Kingdom's government response to the Company Law Review Steering Committee.

It any event, it is not unreasonable to presume that by-and-large creditors engage with companies knowing full well what type of business risks those companies face and (with the exception of involuntary creditors) are willing to assume certain exposure to those risks. It therefore seems logical to focus the directors' discretion on making the chosen line of business successful, rather than requiring them to account to creditors for their actions on the basis of a trust. It would seem that it was with this in mind that courts began to develop the capital maintenance rule as a means of creditor protection.

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[39] Blackman et al *op cit* 8-73.
[40] Sealy, LS 'Directors' "wider" responsibilities – problems conceptual, practical and procedural' (1987) 13 *Monash University Law Review* 164 at 177.
[41] *Ibid* at 181.

4 THE CAPITAL MAITENANCE REGIME

4.1 What is the capital maintenance rule?

The capital maintenance rule is a rule governing a company's capital. According to the capital maintenance rule, capital may not be returned to shareholders, other than by way of a formal reduction of capital. The rule is said to be largely for the protection of creditors, in the sense that the capital of a company may be thought of as a reserve which creditors are entitled at all times to view as a guarantee for the satisfaction of their claims, before it or any portion it may be returned to shareholders in any way. Given the fact that companies are generally not required to generate or sustain any predetermined level of capital as a condition of their incorporation, the term maintenance has been criticised as being misleading, and indeed it is so. If the term 'maintenance' has been criticised as being confusing, the term 'capital' is no less open to interpretation. 'Capital' is generally used in an economic sense to refer to the aggregate resources available to a person for the purposes of investment and trading. But the 'capital' in 'capital maintenance' refers to something far more specific and complicated to define.[42]

The starting point of this instance of capital is best equated with the concept of share capital. Under the existing Act the first point of differentiation between companies is between those that have a share capital and those that do not.[43] It stands to reason that capital maintenance is only of relevance to companies having a share capital. Within share capital there is a distinction to be made between authorised and issued share capital. Authorised share capital is the maximum share capital as stipulated in a company's founding documents that may be issued without having to amend such founding documents. Issued share capital is a subset of authorised share capital and represents the capital actually subscribed for and issued. Share capital is divided into shares and a share represents a complex of rights exercisable by the registered owner against

[42] In the United States the better term 'legal capital' is used to refer to this specific instance of capital.
[43] Section 19 of the existing Act.

the company. The primary distinction to be made as regards shares are between those having a par value and those not having a par value, although there is no fundamental difference between the two.[44] A par value is nothing more than a nominal price indication attached to a share and it has no necessary relationship to the value of the share at any time. Conversely, a no par value share is a share without such a price indicator. Under a capital maintenance regime, whether or not shares have a par value will determine how the subscription proceeds advanced to the company are accounted for in the financial records of the company.

Capital in the legal sense is the sum total of the amounts contributed by shareholders for their shares in the company over time and does not refer to any specific assets. A company's assets are its own and no person, either as a shareholder or as an unsecured creditor, has any equitable lien upon the assets of a solvent company.[45] Capital here is not a res but a monetary quantum.[46] The sentiment can be negatively stated that while the assets of company do not exceed its liabilities by such quantum no assets may be distributed to shareholders. Alternatively it can be positively asserted that distributions of assets may only be made to shareholders if the assets of the company exceed it liabilities by such quantum. The quantum here is determined with reference to the contributions made by shareholders in subscribing for their shares, and the type of shares being subscribed for (being of par value or no par value), i.e. the amount of subscribed capital. Hanks points out that the rules governing this capital have always played a central role in company law because of the significant impact that they have on the allocation of both economic benefit and power within the company framework.[47]

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[44] Blackman et al *op cit* at 5-3.

[45] Ballantine, HW and Hills, GS 'Corporate capital and restrictions upon dividends under modern corporation laws' (1934-1935) 23 *Californian Law Review* 229 at 232.

[46] *Ibid.*

[47] Hanks, JJ 'The new legal capital regime in South Africa' 2010 *Acta Juridica* 131 at 131.

While the value of a company's assets may decrease as a result of perfectly legitimate commercial factors and through no person's fault, in terms of the capital maintenance rule there has to be a positive differential between assets and liabilities to the extent of the subscribed capital, (even when the risk of insolvency is remote) before shareholders are permitted to receive a return, either on or of, their investment. This allows management the freedom to continue exercising unfettered business judgment in conducting the affairs of the company while at the same time protecting creditors from potentially devious action such as declaring dividends or entering into share repurchases in order to drain the company of the funds that would be required to settle creditors. The downside is that because of the complex regulation involved, the subscribed capital became viewed as a hurdle or rather an obstacle to shareholders, with the result that they would rather make loans to their companies than have their investment funds get caught in the web of onerous capital regulation. This has no doubt contributed to the proliferation of companies with nominal subscribed capital.

While the capital maintenance rule is always said to have been for the protection of creditors, creditors are not the only group potentially made vulnerable by alterations of capital. The system of capital regulation is also used to determine the relative entitlement of shareholders to participate in distributions and exercise voting power, and changes to capital can have significant impact on the rights of shareholders.[48] This function of capital regulation is not dealt with in this paper in any detail.

An increase in capital can have no potentially adverse consequences for creditors but shareholders may nevertheless be diluted by the issue of further shares, and that is why management usually have a limited discretion to issue new shares. A reduction of capital on the other hand has the potential to prejudice both creditors and shareholders alike and is

[48] Blackman et al *op cit* at 5-14.

therefore potentially more far reaching. As only formal reductions of capital are permitted in terms of the capital maintenance rule, it is necessary to consider what a formal reduction of capital is.

A formal reduction of capital is a reduction of capital as provided for by statute. Legislatures have always been wary of capital reductions because of the impact that they can potentially have on creditors and shareholders alike. For this reason whether the legislature made direct statutory provision for a reduction of capital or empowered the courts with a wide discretion to condone a reduction of capital, regard would be had to the same factors i.e. were the creditors being protected and was the reduction equitable as between shareholders. Interestingly though, the term 'capital reduction' itself was never defined by statute.[49]

The capital maintenance rule is often referred to as a common law rule but Blackman et al point out that this is not strictly speaking correct. Although the rule was inferred by the English courts in considering the proper interpretation of the then companies act, in truth the rule has its origins in the substrate of companies act itself, being implied by the statutory provision governing the use of a company's capital.[50]

The capital maintenance rule has been subject to much debate and has often been criticised as inappropriate and ineffective. It has subsequently fallen out of common use internationally [51] but the fact remains that it was one of the cornerstones of international company law for almost one hundred years and continues to be of application in the United Kingdom and Europe. It is therefore worth examining the origins of this controversial rule and further considering its full ambit, what it was

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[49] *Ibid* at 5-8.
[50] *Ibid* at 5-105.
[51] Except in the European Union. See further 5.4.

intended to achieve and how it was implemented, before considering its faults and limitations.

4.2 The origin (and purpose) of the capital maintenance rule

Before the enactment of general incorporation statutes, companies were formed pursuant to the passing of special acts. It was a feature of this era that companies were funded almost exclusively by subscribed capital and were public in character. The concept of capital maintenance was inherited from this era although there is no uniform consensus regarding the formal acceptance of the doctrine in the United Kingdom before the decision in *Trevor v Whitworth* [52] in 1889.[53]

It was with the promulgation of general incorporation statutes that companies began to take on a more private nature and that debt financing became such a pervasive feature of the corporate landscape. This in answer to the ever growing need for financing that that marked the advancement of the industrial revolution. [54] It was a feature of those early special acts of incorporation that rules regarding the company's capital be specified. This would typically include the maximum authorised amount of capital and the requisite amount of capital that had to be subscribed for before the incorporation would be effective. (In those days capital reductions would require the passing of an amendment act.)

In the context of companies with stipulated minimum (and often substantial) subscribed capital, it is easy to understand the allure of wanting to use this capital to instil a measure of financial responsibility on the management on companies. The rational for establishing a view that this capital represents, if only on some abstract level, a trust fund

[52] (1887) 12 App Cas 409; [1886-90] All ER Rep 46 50 (HL).
[53] Aiken, M and Ardern, D 'An accounting history of capital maintenance: legal precedents for managerial autonomy in the United Kingdom' (2005) 32 *The Accounting Historians Journal* 23 at 31.
[54] Hank supra (note 45) at 132.

established by the incorporators for the benefit of creditors seems self evident and justified as a *quid pro quo* for the benefits of limited liability afforded the incorporators by the legislature. It was in the famous American case of *Wood v Drummer* [55] in 1824, that Justice Story first asserted this trust fund doctrine as a means of equitably resolving a case that had been poorly pleaded. This principle would however become uncritically embraced and entrenched in the United States, being 'elevated to the sanctity of judicial doctrine by successive courts'[56] In other words, what began as an act on the part of Justice Story to retrospectively prevent a *malafide* distribution by an insolvent company to its shareholders to the detriment of creditors became a fundamental rule of American company law prospectively applied to restrict distributions to shareholders irrespective of the financial health of the company.

The case that is credited as being the first to formalise the capital maintenance rule in the United Kingdom is the case of *Trevor v Whitworth.*[57] In this case the nub of the issue to be decided by the House of Lords was whether a purchase by a company of its own shares amounted to an unlawful reduction of capital, even if it were permitted in terms of the company's memorandum and articles of association. The first general incorporation statute in England was the Companies Act 1862 and it made no provision for a reduction of capital. The Act was subsequently amended in 1867[58] to make allowance for a reduction of capital under certain carefully worded conditions aimed at protecting the interests of creditors.[59] Such condition included the confirmation of the court and the consent of creditors or the securing of their claims.[60] The three pronouncing lords in *Trevor v Whitworth* make numerous references to role of subscribed capital in protecting the interests of creditors. It was

[55] (C.C.D. Me. 1824) Fed. Cas, No. 17944.
[56] Norton, JJ 'Relationship of shareholders to corporate creditors upon dissolution: nature and implications of the "trust fund" doctrine of corporate assets' (1974-1975) 30 *Business Law* 1061 at 1062.
[57] *Supra* (note 47).
[58] Companies Act 1867 30 & 31 Vict c 131.
[59] *Ibid* Lord MacNaughten at 438.
[60] Blackman et al *op cit* at 5-104.

unanimously held that as the legislature had gone to the trouble of carefully detailing the manner and procedure of effecting a reduction of capital, it could be inferred with certainty that any other manner of reducing capital was accordingly unlawful, even though purportedly authorised by the company's founding documents. While capital could be lost in the pursuit of the company's stated objectives, it could not be returned to shareholders in any manner other than under a formal reduction of subscribed capital.

This meant any arrangement or agreement that in substance resulted in any amount that shareholders had paid for their shares being returned to them was illegal and therefore void, irrespective of the form that the arrangement was effected in. It would be for the court to decide on the merits of the evidence presented in each case whether a payment in question was in fact a return of subscribed capital.[61] (See further 4.4)

The capital maintenance rule as embodied in the early English decisions was unquestionably adopted into South Africa company law from the outset[62] and was echoed in the case of *Cohen v Segal*.[63] The capital maintenance rule is said to rest upon various sub-rules,[64] we will now consider each in turn.

4.3 Additional rules that gave rise to a capital maintenance regime

4.3.1 Dividends not to be paid out of capital

It was understood that there was a prohibition on the payment of dividends out of capital even before the judgement in *Trevor v*

[61] *Ibid* at 5-106.
[62] Pretorius et al supra (note 36) at 121.
[63] 1970 (3) SA 702 (W) 705-706.
[64] Cassim, FHI 'The reform of company law and the capital maintenance concept' (2005) 122 *SALJ* 283 at 285.

Whitworth [65] in 1889. Lord Campbell had in 1849 in the case of *Burnes v Pennell*[66] clearly stated that '...dividends are supposed to be paid out of profits only...', and the Limited Liability Act of 1855 [67] provided for personal liability to creditors for directors who declared a dividend that rendered a company insolvent.[68] This is in any event the situation that would have most likely prevailed under the application of the Statute of Elizabeth.[69] The payment of dividends would not be expressly regulated by statute in England until 1980 but the concept was very much a part of English law. This specific prohibition followed the general understanding that capital could not be returned to shareholders other than in terms of a winding up or a formal reduction of capital. [70] The decision in *Trevor v Whitworth* cemented this understanding.[71] This was adopted in South Africa as set out above.

4.3.2 Company prohibited from purchasing its own shares

This prohibition stems directly from the decision in *Trevor v Whitworth* and was echoed in the South African case of *Sage Holdings v Unisec Group Limited & others* [72] and *Capitex Bank v Qorus Holdings Limited & others.* [73] The purchase by a company of its own shares amounts to a return of capital to shareholders and accordingly the company's capital is reduced, thus decreasing the capital fund available to creditors. Any capital reduction otherwise than in terms of the statutory scheme is illegal and therefore invalid even if the memorandum and articles expressly permits such purchases. The prohibition of such purchases eschews circumvention

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[65] (1887) 12 App Cas 409; [1886-90] All ER Rep 46 50 (HL).
[66] 2 H. L. Cas 497 (1849).
[67] 18 &19 Vict. c. 133 (1855).
[68] Weiner, JL 'Theory of Anglo-American dividend law: the English cases' (1928) 28 *Columbia Law Review* 1046 at 1048.
[69] The Statute of Elizabeth 1571 was a statute passed to formalise the common law in England in relation to fraudulent conveyance to defraud creditors. See Weiner *Ibid.*
[70] Blackman et al *op cit* at 5-107.
[71] Ballantine and Hills supra (note 43) at 245.
[72] 1982 (1) SA 337.
[73] [2003] JOL 12125 (W).

of the capital reduction provisions and furthermore protects shareholders from the company trafficking in its own shares. In the case of *Sage Holdings v Unisec Group Limited & others* the court commented that this principle was so fundamental that it was not even expressly contained in legislation until after 1926 and even then subsidiaries were not specifically covered. An extension of this rule by statute in 1973 meant that a subsidiary company was also formally prevented from becoming a member of its holding company. This entrenched in statute the common law understanding that a holding company was not permitted to indirectly purchase its own shares.

There were however statutory exceptions that were permitted without jeopardising the position of creditors or shareholders. The courts was empowered with a discretion to order the purchase by a company of its own shares in the interests of equity under the section 252 of the existing Act; and preference shares could be redeemed out of profits or the proceeds of a fresh issue of shares in terms of section 98 of the existing Act.

Closely linked to the purchase by a company of its own shares, is the provision of financial assistance by a company for the purpose of enabling the lender to acquire its own shares. Although the provision of financial assistance for the purchase of the company's own shares does not necessarily impoverish the company, the potential for blatant abuse prompted legislatures to disallow even the most innocent and commercial sound applications of such an arrangement. It has been pointed out that the scope of this prohibition is wider than simply an extension of the rule that companies cannot reduce their capital by acquiring their own shares as it also relates to situations in which control could be abused.[74] In South Africa this found expression in section 38 of the existing act, a wide and far

[74] Blackman at el *op cit* at 4-57 quoting from Cilliers and Benade.

reaching provision. Judge Nicholas said of section 38 in the case of *Lewis v Oneanate (Pty) Ltd*[75] that '[t]he object of a provision like such as 38(1) is the protection of creditors of a company, who have a right to look to its paid-up capital as the fund out of which their debts are to be discharged' and relied on the authority in *Trevor v Whitworth.*[76]

4.3.3 Prohibition of issue of shares at a discount

This prohibition was also consistent with the inability to reduce capital otherwise than in the approved manner. Shareholders were required to pay for their shares in full in order to limit their liability for the company's debts.[77] This principle was expressed in a number of early English cases[78] and became part of South African company law from its inception.

4.4 The return of capital : a question of substance over form

4.4.1 The general principle

In the case of *Verner v General and Commercial Investment Trust*[79] Lindley LJ stated in 1894 that '[t]he statutes do not even expressly and in plain language prohibit a payment of dividend out of capital. But the provisions as to capital , when carefully studied, are wholly inconsistent with the return of capital to the shareholders, whether in the shape of dividends *or otherwise*, except, of course, an a winding up...The fact is that the main condition of limited liability is that capital of a limited liability company shall be applied for the purposes for which the company is formed, and that to return the capital to the shareholders either in the shape of dividend *or otherwise* is not such a purpose as the Legislature intended.' [*Emphasis mine.*]

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[75] 1992 (4) SA 811 (A) 818.
[76] *Supra.*
[77] Blackman et al *op cit* at 5-109.
[78] See Blackman et al *ibid* for a list of cases.
[79] [1894] 2 Ch 239 264 (CA).

It was thus clear from early days that any action or transaction which in substance amounted to a return or reduction of capital to shareholders would not be permitted, even though such action or transaction was purported and technically presented as legitimate. The same sentiment was expressed almost one hundred years later in *Aveling Barford v Perion Ltd*[80] by Hoffmann J as follows '[w]hether or not a transaction is a distribution to shareholders does not depend upon what the parties choose to call it. The court looks at the substance rather than the outward appearance.' Let us now consider by way of examples some of the actions and transactions that courts have struck down as being a sham for the purpose of effecting a distribution to shareholders.

4.4.2 *Ridge Securities Ltd v Inland Revenue Commissioners*[81]

In this case a solvent company entered into a tax avoidance scheme that involved the issuing of a debenture to its holding company under which excessive interest payments were required. The court held that such payments were noting more than 'gifts of capital' disguised to look like interest and were consequently *ultra vires*.

4.4.3 *Re Halt Garage*[82]

Excessive directors' remuneration was to method employed in this case, but the courts saw through the deception. A director, who was also a shareholder, was paid handsomely for the holding of office while rendering to services to the company. It held that while companies were entitled to pay (even liberal) remuneration for services rendered this did not extend to using it as a 'cloak for making payments out of capital to shareholders…' and the situation was

80 [1989] 5 B.C.C 677.
81 [1964] 1 W.L.R. 479.
82 [1982] 3 All E.R. 1016.

likened to the case of *Ridge Securities Ltd v Inland Revenue Commissioners*.

4.4.4 *Aveling Barford v Perion Ltd*[83]

In this case a company having no distributable reserves sold an asset to another company controlled by the same beneficial shareholder for a sum of GBP350,000, which the second company was able to sell for GBP1,500,000 within a six month period. The courts held that although the transaction was in law a sale, '...[t]he false dressing it wore was that of a sale at arms' length or at market value. It was the fact that it was known and intended to be a sale at an undervalue that made it an unlawful distribution'.

4.4.5 *Redweaver Investments Ltd v Lawrence Field Ltd*[84]

In this case a subscription agreement contained a clause that should the subscriber fail to realise certain expected monetary benefits from the issuing company within a specified time frame, the company would be liable to make a payment in respect of 'damages' to the subscriber by way of compensation. When the expected benefits failed to materialise, the subscriber sought to enforce the payment of the contractual damages amount. The court held that the arrangement was '...quite artificial ; the reference to damages and to liquidated damages is no more than nominal, and the true and obvious subject is machinery for the plaintiff to get back the subscription moneys...'. Accordingly it found that agreeing to make such a payment was illegal and the purported contractual obligation was therefore not enforceable.

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[83] *Supra.*
[84] (1991) 5 ACSR 438 SC (NSW).

4.4.6 *Rosslare (Pty) Ltd and Another v Registrar of Companies*[85]

This case was considered prior to the promulgation of the Sectional Titles Act[86] and involved an overzealous attempt by the Registrar of Companies to prevent a share block company from altering its articles of association after the fashion of the time. Why the Registrar took exception in this particular case after registering many such similar amendments is not clear. The court distinguished this case from the decision is the similar case of *Jenkins v Harbour View Courts Ltd*[87] and held that the granting of an interest in immovable property to a member (i.e. the distribution of an asset) of a value equivalent to the capital subscribed was not a return of capital, because the purchase of the immoveable property had been funded by means of shareholders loans and not share capital.

This then is how the courts have viewed disguised returns of capital. Let us now examine the regulatory framework pursuant to the implementation of the capital maintenance regime, before the enactment of the Companies Amendment Act No. 37 of 1999 (hereinafter 'the amendment Act').

4.5 The legislative framework in South Africa pre-1999 underpinning the capital maintenance regime

Chapter V of the existing Act is entitled Share Capital and contains the complex web of regulation surrounding capital. Section 74 makes allowances for the division of share capital into both par value and no par value shares, although all the shares of a particular class, being either ordinary or preference shares, are to be either of par value or of no par value.[88] Section 75 dealt with alterations of share capital.

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[85] [1972] 2 All SA 354 (D).
[86] Act No. 66 of 1971.
[87] [1966] NZLR 1.
[88] Section 74 of the existing Act.

Sections 76 to 82 contain the onerous provisions regarding the way that the proceeds on the issue of different types are to be accounted for, that is the structure of a company's capital accounts and the restrictions as to the application of those accounts.

Sections 83 to 90 of the existing companies Act contained the provisions governing the formal reduction of capital before the promulgation of the amendment Act. These rules were aimed at ensuring that the interest of creditors and shareholders were protected when capital was reduced. Creditors' concerns in this situation centre around the diminution of the capital fund and its potential effect on settlement of their claims, while shareholders interests would be affected by the alternation of their rights incumbent upon a capital reduction. Blackman et al point out that in strict terms these rules did not form part of the capital maintenance rule but rather served as a justification of the capital maintenance rule. The fact that that these provision so carefully and comprehensively dealt with capital reductions inevitably and naturally lead one to the conclusion that they dealt with capital reductions exhaustively, and that by implication no other means of capital reductions could be countenanced.[89]

Sections 38 and 98 also had a role to play in capital maintenance, dealing with financial assistance for the purchase of a company's shares and redeemable preference shares respectively.

Section 83 was an innovation when into was promulgated in 1973. It permitted a company to reduce its share capital by special resolution and without the confirmation of the court provided that the company either had no creditors or had the consent of all creditors; and that all classes of

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[89] Blackman et al *op cit* at 5-104.

shares were affected in equal proportion.[90] Sections 84 to 86 contained the standard provisions granting a company to reduce capital with the permission of the court.

4.6 The problems with the capital maintenance regime

Statements that the function of the capital maintenance regime is to serve as a protection mechanism for creditors' interests feature prominently in all judgments concerning capital maintenance.[91]

While the theoretical basis upon which the capital maintenance regime rests is sound i.e. that creditors' interests are deserving of the protection of company law as a *quid pro quo* for the limited liability enjoyed by shareholders[92], in practice the capital maintenance regime does not achieve what so many courts have insisted it does and is practically of little or no comfort to creditors.

Many have pointed out that creditors are instinctively aware of the short comings of the capital maintenance regime as a form of creditor protection and as a consequence place no reliance upon it. This raises the question of whether the costs of adhering to a capital maintenance regime are justified given that the intended beneficiaries of the system place little or no value on the end product. The costs involved are both direct and indirect in nature. Direct costs include the princely sums payable to accounting and legal experts that necessarily accompany any capital restructuring or distribution; and indirect costs include the burden of inefficiencies and of having the judiciary enforce an overly-complex set of rules. In fact the inefficiency of the capital maintenance regime has been

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[90] Blackman et al *op cit* 5-10.
[91] To name but a few: *Trevor v Whitworth*; Guinness v Land Corporation of Ireland (1882) 22 Ch D 349 CA; *Verner v General and Commercial Investment Trust*; *Ammonia Soda Co Ltd V Chamberlain* [1918] 1 Ch 266 CA; *Ooregum Gold Mining Company of India v Roper*; *Cohen v Segal* .
[92] Cassim *supra* (note 62) at 284.

the object of much criticism. Such criticisms ranges from the stifling effect that it has on dividend declaration and hence how it hampers the communication of important information via market mechanisms, to the fact that more efficient means of creditor protection exist, such as voluntary creditors contractually: demanding higher interest rates to compensate for increased levels of risk, imposing restrictions on distributions, requiring the maintenance of pre- determined financial ratios or requiring the provision of personal guarantees or suretyships. Cassim concedes the inefficiency of the capital maintenance regime but for him the rules remain justifiable to the extent that they counter opportunistic shareholder behaviour and excessive distributions.[93] Even so he recognises that 'capital maintenance rules are unnecessarily complex and riddled with obscurities, but worse still, many of these rules have outlived their usefulness.'[94]

I have already alluded to the fact that the term capital maintenance is an inaccurate expression of what the rule actually achieves. There is no maintenance in the sense that if the value of the assets represented by the capital contributed is diminished in the course to business there is no requirement whatsoever that such loss should be made good. Staying with Cassim, he rightly asserts that '[t]he classical capital maintenance concept has got nothing to do with ensuring that a company has adequate capital to meet the claims of creditors. All that this concept attempts to do is to endure that the issued share capital of a company – whatever this amount may be – is maintained in the sense that the company does not return its issued share capital to its shareholders except where this is authorised by the Companies Act.'[95]

The general absence of minimum capital requirements is also a significant shortfall. Even where there are legislated initial minimum

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[93] Cassim *supra* (note 62) at 284.
[94] *Ibid.*
[95] *Ibid* at 285.

capital requirements, such as in the European Union, these do not take into account the size and scope of the particular company's business nor the inherent risk in the nature of its operations. A one-size-fits-all approach is simply not tenable. Enriques and Macey further note that the implementation of the extreme 'recapitalise or liquidate rule' in certain European Union Member States, while more robust in its approach to protecting creditors, in fact runs counter to the very essence of limited liability and affords opportunistic shareholders increased scope for skulduggery and manipulation i.e. effective regulatory arbitrage.

A contention that the capital maintenance regime provides some form of financial accounting yardstick facilitating the protection of creditors can be countered on many fronts. Firstly, accounting data is historic in nature and a corporate balance sheet has no necessary link with market values and economic reality. What is more, there are inherent limitations in financial accounting such as not being able to reflect the inherent value of goodwill on a company's balance sheet or human resources as an asset, both of which factors play a major role in the economic sustainability of a company. Secondly, accounting has developed (if indeed it can be called development, some may be tempted to say devolved) to the point at which it has become a simulacrum, operating in a '"hyperreality" of self-referencing models'.[96] In other words financial accounting has become an arbitrary exercise, practically leaving management much discretion in determining amongst other things, distributable profits. Thirdly, the community of 'independent' accounting and auditing specialists that is required to enforce the desired protection, in addition to having a myriad of valuation techniques at their disposal capable of justifying a wide range of outcomes, can never act truly independently in an expert role, being inherently conflicted by the economic reality of having to generate new and repeat business for themselves.[97] Fourthly, equity capital is no longer

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[96] Macintosh, NB et al 'Accounting as simulacrum and hyperreality: perspectives on income and capital' (2000) 25 *Accounting, Organisations and Society* 13.
[97] Enriques, L and Macey, JR 'Creditors versus capital formation: the case against the European legal capital rules' (2000-2001) 86 *Cornell Law Review* 1165 at 1187.

the predominant method of financing companies that it was when the capital maintenance concept was birthed. The increased dependency on debt means that there is all too often only nominal capital to maintain in any event.

Fundamentally, many these of these problems exist because the entire rationale for the legal capital scheme is based upon a simplistic and static model of nature of business and creditors' interests.[98] With all these reservations about the capital maintenance regime it was only a matter of time until alternative means of creditor protection was sought.

[98] Manning, B with Hanks Jr, JJ *Legal Capital* 3ed (1990) at 22 .

5 THE INTERNATIONAL TREND AWAY FROM THE CAPITAL MAITENANCE REGIME

5.1 Solvency and liquidity requirements

5.1.1 What are solvency and liquidity requirements?

If creditors are in practice more concerned with the economic viability of a company than its capital structure and capital accounts, it raises the question of how best to protect this economic viability whilst maintaining a balance between the conflicting interests of shareholders and creditors when it comes to matter concerning distributions of any sort to shareholders.[99] Shareholders cannot be expected to wait until all creditors claims are settled in full before being permitted to share in the wealth created by the company. Indeed, given the secondary financial interests of creditors that I highlighted in part 3.2 above, such a *modus operandi* would necessitate, in essence, a partial liquidation or realisation of a company's trading position each time shareholders wished to extract value from the company, and would in fact run counter to the broader interests of creditors. Provided distributions are carried out in a responsible manner such that the economic viability of the company in not compromised by the distribution itself and further provided that their claims are regularly serviced, creditors should not in principle have any objection to shareholders receiving value from the company in the form of such distributions, even while their claims remain outstanding. It is contended that this is what the capital maintenance doctrine has tried to achieve all along. However, its methodology and implementation proved to be ineffective, overly complex and too restrictive for shareholders.[100] And this is where solvency and liquidity requirements enter into the picture.

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[99] *Ibid* at 14.
[100] The use of legal capital as a system to achieve equity between shareholders *inter se* is beyond the scope of this paper and will not be addressed in any detail.

Solvency and liquidity are two important legs of economic sustainability. In simple terms, solvency is generally defined as a situation in which the value of a company's assets exceed it liabilities, (where such liabilities may or may not include the right of preference shareholders to dividend payments). Liquidity generally describes the ability of the company to meets it debts during a foreseeable time period, often expressed as twelve months. It has been argued that creditors are primarily, and more specifically, concerned only with the ability of the company to meet its obligations as they fall due i.e. the solvency test and not so much with the valuation of companies' assets as they appear on the balance sheet[101], but consideration of this point is beyond the scope of this paper and further analysis of this contention will not be entertained here.

The premise of solvency and liquidity requirements rests upon the company being able to meet both such tests post any distribution, with potential for personal liability arising for directors who authorise any distribution in contravention. This eases creditors' minds given that directors are appointed by, and most likely to act in accordance with the wishes, of shareholders (at least if they wish to retain their position). Personal liability is the threatened sanction used to concentrate directors' minds and mitigate the fact that - as Manning so eloquently puts it – hungry goats have been set to watch the cabbages.[102]

It is ironic that the use of solvency and liquidity requirements first found favour in the United States, because the seed had been planted in England almost four hundred year earlier. While on the one hand the use of solvency and liquidity measures to safeguard the interests of creditors may be seen as a new development, on the other

[101] Hanks *supra* (note 45) at 148.
[102] Manning *op cit* at 16.

it can be argued that solvency and liquidity requirements are nothing more than a pragmatic way of achieving the protection offered creditors under the application of the Statute of Elizabeth of 1571. Nevertheless let us further examine the modern evolution of solvency and liquidity requirements in the United States and internationally over the past thirty years.

5.2 The USA leads the way

There is a philosophical divide between the approaches to creditor protection in the United States and the United Kingdom.[103] While the United Kingdom adopts a paternalistic stance, wanting to proactively shield creditors, in the United States creditors are largely expected to fend for themselves via contractual arrangements. In the United States it was thus decided that employing safeguards built around solvency and liquidity, rather than a restrictive legal capital regime, was a more efficient and palatable method of affording creditors some measure of protection.

Bayless Manning was one of the foremost critics of the system of legal capital in the United States. In his definitive work *Legal Capital*[104] he asserted that the entire legal capital scheme is based upon a static and skewed model of creditors' interests that values the assets contributed by the shareholders of the company over time, above more pragmatic and real concerns such as cash flow considerations. He goes on to bemoan the fact that this theoretical construct is solely a legal invention that grew out of nineteenth century jurisprudence and '...is not relatable in any way to the ongoing economic conditions of the enterprise.'[105] Manning's work was first published in 1977 and in the preface to that first edition he aired a suspicion that, despite its short comings, the then exiting system of legal

[103] Since its entry into the European Union and the 2nd Company Law Directive, the United Kingdom is also reflective of the stance of the European Union.
[104] Manning *op cit* at 18 – 22.
[105] *Ibid* at 39.

capital would prove durable. He was however to be pleasantly surprised. In 1980, after an extensive study, the American Bar Association's Committee on Corporate Laws revised the Model Business Corporations Act, a statute drafted and maintained by some of the America's best legal minds and which serves as the basic incorporation statute of most states', in a revolutionary manner inconsistent with the incumbent legal capital regime. Subsequent further revisions in 1984 and 1987 saw the legal capital doctrine removed altogether. There were no longer any capital accounts and hence the concept of a capital reduction could not even arise. All shares were to be of no par value and all distributions i.e. dividends, redemptions, repurchase or otherwise, were subject only to liquidity and solvency tests. Preference shareholders rights are protected by adding the amount to which they have preferent right to liabilities under the solvency test. [106] This remains the case in most jurisdictions in the United States today.[107] It should be noted that the terminology employed in the United States is slightly different. While the solvency test as we know it retains its name, in some circles it is alternatively referred to as the balance sheet solvency test or just the balance sheet test; and the liquidity test as we know it is referred to as the equity insolvency test, the equity solvency test or simply the equity test.

5.3 Commonwealth jurisdictions follow

Let us now briefly consider the international trend among Commonwealth countries.

While the capital maintenance principle continues to apply in Canada i.e. legal capital may only be reduced as specifically provided for by statute, the Canadian Business Corporations Act 1985 relaxed the requirements for such formal reductions of capital. Dividends may still not be paid out of capital. Only no par value shares are permitted and the

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[106] Blackman et al *op cit* at 5-115.

[107] The state of Delaware is a noteworthy exception.

company still has a system of stated capital accounts but the procedure for a reduction of capital no longer requires creditors consent and confirmation by the court. Instead compliance with solvency and liquidity requirements are substituted for creditor and court permission.[108] Australia adopted a similar approach from 1998.[109] These approaches represent a middle-road between the historical capital maintenance regime and its renunciation in favour of solvency and liquidity requirements.

New Zealand adopted a new companies act in 1994[110] that closely follows the American Model Business Corporation Act in principle.[111] Prior to this New Zealand followed the capital maintenance doctrine but in addition had common law that required compliance with solvency and liquidity requirement for distributions to shareholders.[112] The capital maintenance doctrine is now completely abolished as is the use of the legal capital system to regulate shareholder relationships – a company need not even have share capital as a prerequisite for incorporation. In its place are solvency and liquidity requirements for all distributions to shareholders thus protecting creditors; and a flexible system consisting of pre-emptive rights and a positive duty on directors to consider the fairness of company share transaction with shareholder thus addressing existing shareholder vulnerability.

This then is how selected common wealth countries chose to embrace the movement started by the United States, but how has the United Kingdom, the home of capital maintenance, responded to these international developments.

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[108] Blackman et al *op cit* at 5-113.
[109] Ibid at 5-114.
[110] Companies Act No 105 of 1993.
[111] Blackman et al *op cit* at 5-111.
[112] Van Der Linde, K 'Aspects of the regulation of share capital and distributions to shareholders' (2008) Unpublished LLD Thesis, Unisa at125.

5.4 The United Kingdom persists with capital maintenance

The United Kingdom is part of the European Union and as such has given up a certain amount of autonomy over deciding it own path when it comes to among other things, corporate law making. Over the past decades the European Union has been on a quest to harmonise the corporate law of member states to ensure an acceptable level of homogeneity, thus limiting unhealthy competition and the possibility for regulatory arbitrage between member states. This has been achieved through the issuance of directives binding upon member states. The directive relevant to the current discussion is the Second Company Law Directive of 1976[113] that requires public companies maintain their legal capital. It is interesting to note that the capital maintenance regime that prevails in the European Union is not the work of union law makers. Rather it was inherited largely from individual member states' (most German) legislation[114] and has subsequently become entrenched in European legal culture. Because the Second Directive is only applicable to public companies, the possibility exists for individual member states to introduce different legislation (such as would include solvency and liquidity requirements) governing private companies, but the wisdom in introducing radically different regulatory scheme within the same jurisdiction has been questioned. There is also nothing preventing member states from adopting solvency and liquidity requirements in addition to the capital maintenance regime, although this comes with the caveat of over-regulation.

The European Union has taken note of the international trend away from capital maintenance and toward solvency and liquidity and even went so far as to commission a leading accounting firm to undertake a comprehensive study of the alternatives to the approach adopted under the Second Directive, with a view to remaining internationally competitive . Those with a jaundiced eye may say that given the accounting (and legal)

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[113] Directive 77/91/EEC hereinafter the 'Second Directive'.

[114] Kuhner, C 'The future of creditor protection through capital maintenance rules in European law' (2006) ECFR Special Volume 1 *Legal Capital in Europe* 341 at 343.

professions' vested interest in maintaining a legal capital system because of all the professional fees that result as an unavoidable consequence, it is hardly surprising that the report by KPMG published in 2008 concluded that '...the Second Directive is a flexible instrument, that compliance costs are limited, and that it does not cause significant operational problems for companies...'.[115] On the basis of the report the commission decided not to pursue any substantive amendments to the Second Directive.

It is in this context that the United Kingdom conducted its extensive process of corporate law reform that culminated in the strengthening of its capital maintenance regime in the Companies Act 2006. Under the Companies Act 2006 public companies are required to ensure that the value of it net assets do not fall below the level of its legal capital and a minimum legal capital of GBP50,000 applies.[116] Dividends may only be paid out of profits determined in accordance with rules that require accumulated realised losses to be netted off against accumulated realised profits in calculating such profits; and capital reduction are only permitted with the familiar requirements of creditor and court consent. Repurchases and redemptions are treated in the same fashion only being permissible if funded out of profits or the proceeds of a fresh issue, with the creation of a capital reserve redemption fund being required where profits are utilised. [117] Non-distributable reserves are thus the order the day for public companies.

In respect of private companies the United Kingdom has made a concession in allowing repurchases and redemptions to be fund out of capital subject to solvency and liquidity requirements. Ferran points out

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[115] Ferran, E *Principles of Corporate Finance Law* (2008) at 180.
[116] The Second Directive only requires EUR25,000 by way of comparison.
[117] Blackman et al *op cit* at 5-110. Although Blackman is referring to the Companies Act 1985, very little other than the abolition of the concept of authorised share capital has changed in relation to capital maintenance under the Companies Act 2006.

that the different approaches to creditor protection for public versus private companies is oddly inconsistent and peculiar.[118]

5.5 The drawback of solvency and liquidity requirements

Solvency and liquidity requirements have not been around long enough to conclusively determine which system is superior and only competition between the two systems over time can ultimately be the judge. One should not under estimate the longevity of the legal capital system.[119] Every system has its limitations and it would be remiss not to consider, even if very briefly, the counter arguments to solvency and liquidity requirements as a wholesale replacement for the capital maintenance system.[120]

Because solvency and liquidity requirements are essentially based upon a determination by the directors of the ability of the company to pay its debts in the future, and because it is not reasonable to expect directors to assume responsibility for the affairs of a company far into the future when they may no longer even serve as a director, the time horizon that can practically be used for such purpose is limited and usually regarded as about one year from either the decision to make a distribution or the actual payment thereof. This means that solvency and liquidity requirements have an inherent short-term bias and that long-term creditors are therefore prejudiced as a matter of course. It is not clear how such long-term interests should be catered for and this has been a major reservation among those resisting change. Another criticism is that a breach of solvency and liquidity requirements can only ever be detected after the distribution and that as a result the system is reactive rather than preventative in nature. Although it may well be argued that 'flexible *ex*

[118] Ferran *supra* at 183.
[119] Khuner s*upra* (note 113) at 364.
[120] For this section I have used Ferran s*upra* at 182.

post standards are inherently preferable to rigid *ex ante* standards' these present the more credible criticisms.

Other criticisms of the system, as a replacement in Europe, include the fact that because the legal capital regime is so deeply entrenched, to change the system would cause great confusion and incur substantial adaptation costs and that liability rules for management would need to be expanded and better enforced.

6 SOUTH AFRICA ABOLISHES THE CAPITAL MAINTENANCE REGIME IN FAVOUR OF SOLVENCY AND LIQUIDITY REQUIREMENTS

6.1 Amendment Act No. 37 of 1999

South African company law had, true to its English law heritage, followed the capital maintenance principle. This all changed with the amendment of the existing Act in 1999. Sections 83 to 90 of the original 1973 Act were repealed and substituted by sections 8-14 of the amendment Act. The rules contained in the repealed sections provided the means of a formal reduction of capital and required a special resolution and the standard creditor and court consent. Jooste makes the points that without these enabling sections a company now no longer has a general power to reduce its share capital other than by way of buy backs.[121] Although these rules were not in themselves the capital maintenance doctrine, they provided the justification for the doctrine as further discussed in part 4.1 above. Jooste's argument that to allow reductions of capital at will would completely disregard the other important function of capital maintenance (other than the protection of creditors interests' that is) being a means of regulating shareholder power and entitlements, and that it could never have been the intention of the legislature to disregard shareholder rights, is very persuasive.

The new sections 85- 89 deal with the acquisition by a company of its own shares i.e. buybacks, the required procedure and some of the consequences thereof. Section 85 put an end to the common law general prohibition of a company purchasing it own shares. It provides that a company may by special resolution and if authorised by its articles acquire it own shares subject to liquidity and solvency test contained in the section 85(4) under either a specific or general authority. It requires the share so acquired are cancelled and returned to the status of authorised and unissued thereby ruling out the possibility of treasury shares.

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[121] Jooste, R 'Can share capital be reduced other than by way of a buyback?' (2005) 122 *SALJ* 294 at 294.

Section 86 deal with liability attaching for offending payments. Section86(1) makes provision for joint and several personal liability on the part of directors who permit a company to acquire its own sharers in contravention of the solvency and liquidity requirements of section 85(4). The liability is to the extent of any amount paid by the company for such shares not otherwise recovered, subject to any relief granted under section 248. Section 86 (3) makes allowance for a creditor who is prejudiced by a payment in contravention of section 85(4) to apply to court for an order in equity, and grants the court a wide discretion to, among other things, order the shareholder recipients of payments to return them the company.

Section 87 deals with the procedure to be followed by the company when making an offer to acquire its own shares. It requires an offering circular containing certain specific information to be delivered to shareholders and applies the same stringent liability rules applicable to the issue of a prospectus to such offering circular. Shareholders of the same class are to enjoy equal treatment.

Section 88 makes it clear that any contract which results in the company acquiring shares contrary to the provisions of section 85(4) is not enforceable against the company and places the onus of proof on the company.

Section 89 permits subsidiaries to acquire up to ten percent of the shares in its holding company without the need to cancel them. (Section 39 understandably provides that such shares will be excluded for voting purposes.) This is as close as South African law comes to allowing treasury shares.[122]

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[122] See Cassim, FHI 'The challenge of treasury shares' 2010 *Acta Juridica* 151 for a discussion of why and how the use of treasury shares is facilitated in certain jurisdictions. Cassim concludes that

The new section 90 was the most striking and far reaching development of the 1999 amendments. It abolished the rule that dividends could not be paid out of capital. Section 90 permits, if authorised by the articles, 'payments' to shareholders provided that the solvency and liquidity requirements contained in subsection (2) are met. A 'payment' is defined as any direct or indirect payment, transfer of money or other property to a shareholder by virtue of their shareholding, but excludes buy-backs, redemptions, the issue of capitalisation shares and shares acquired pursuant to a court order. Buy-backs are separately dealt with in sections 85 to 89 as outlined above. Redemptions are separately dealt with under section 98 and can only be out of profits or the proceeds of a fresh issue. Capitalisation issues are funded out of profits so their exclusion is understandable as is the protection of court discretion.

Section 90 means that a company can pay shareholders out of the capital fund reserved for creditors without having to formally reduce capital and alter its capital accounts, provided that the solvency and liquidity tests are met. Because the company's capital accounts are not affected, shareholders' rights upon winding up are not impacted. Post the new section 90 non-distributable reserves are therefore something of the past, even though section 87(5) still refers to share premium and capital reserve redemption fund as such.

The new section 90 brought South Africa into line with the international trend away from the capital maintenance regime.

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disallowing treasury shares runs counter to the Department of Trade and Industry's stated policy goal of providing 'flexibility in the design and organisation of companies' and the prohibition should be reconsidered.

6.2 Anomalies remain – a hybrid approach

Cassim and Cassim capture the position under the existing companies act succinctly as follows. '[t]he South African Companies Act 61 of 1973 adopts a strange and curious ambivalence toward the nineteenth-century common law concept of the maintenance of the share capital of a company. In some respects, the Companies Act still clings to this archaic and outdated concept, while in other respects, it boldly sweeps away the concepts and replaces it with the more modern twin tests of "liquidity" and "solvency" as a form of creditor protection.[123]

It is indeed odd that a dated provision like section 79 prohibiting the payment of interest on share capital should survive alongside a progressive provision such as section 90 that in any event permits payments in nature such as those that section 79 is aimed at preventing.

It is also a mystery why buy-backs under section 85 and payments under section 90 are subject to solvency and liquidity requirements, while in respect of redemptions, which are also distributions in substance, the old fashioned concept of profits available for dividends remains as a funding option (along with the proceeds of a fresh issue) and no regard is to be had to solvency and liquidity. The retention of par value shares and the stated capital concept also seem out of place under a solvency and liquidity dispensation.

When the amendment act was passed, section 38 was altered to permit a company or its subsidiary to provide financial assistance for the purchase of its own shares only in connection with a buy-back under section 85. Some view the section 38 prohibition against the provision by a company of financial assistance for the purpose of or in connection with

[123] Cassim, FHI and Cassim, R 'The capital maintenance concept and share repurchases in South African law.' 8 October 2004. Available at http://www.bowman.co.za/LawArticles/Law-Article~id~-639353216.asp .

the acquisition of its own shares as a mere extension of the rule to protect creditors that a company may not purchase its own shares, and therefore simply regard the fact that section 38 was not amended to include solvency and liquidity criteria as an oversight on the part of the legislature. It has been noted however that the aim of the section 38 prohibition is to achieve more than just the protection of creditors. A potentially devastating abuse that section 38 is aimed at is the use of company funds for improper purposes, such as employing the company's resources to fund a leveraged buy-out i.e. assets- stripping; or to thwart a takeover bid.[124] Cassim is of the view that section 38 plays a crucial role in our company law and that reform of the provision as in the United States, where only solvency and liquidity requirements need be met, is not adequate to protect minority shareholders from directors misusing company resources.[125] This view is shared by the authors of Hahlo's South African Company Law through the Cases who see a continued need for the section 38 prohibition. [126] Whether or not the legislature took cognisance of this when it showed restraint in the 1999 amendments is open to debate, but by 2006 the tide had turned and section 9 of the Corporate Laws Amendment Act No. 24 of 2006 amended section 38 to permit financial assistance provided that solvency and liquidity requirements (now contained in section 38(2A)) are met and that the terms of the assistance are sanctioned by special resolution. Minority shareholders thus remain vulnerable.

Section 90 has also been subject to criticism. Notable shortcoming are that it does not clearly state when the tests are to be satisfied, i.e. when the payment is first contemplated or when it is actually made; it does not offer any guidance as to for how long after a payment a company must remain solvent and liquid, the incurring of a debt is not expressly included in the definition of payment,[127] it does not address director liability for offending

[124] Cassim, FHI 'The Reform of Company Law and the Capital Maintenance Concept' at 291.
[125] *Ibid.*
[126] At 125.
[127] Blackman et al at 5-118-1.

payments and a special resolution is not required as would be the case for buy backs under section 85. Furthermore, while shareholders are liable to the company for any amount received in contravention of the solvency and liquidity requirements contained in section 90(2), creditors do not have right to challenge a payment in court as they do under section 85. But perhaps the most pointed criticism of section 90 (and in fact section 85 too) is that its solvency and liquidity tests do not factor in the rights of preference shareholders. In other words because obligations to preference shareholder are not necessarily treated as liabilities for the purposes of the tests, a company can legally pay away all of its net assets to ordinary shareholders, without having regard to the claims of preference share holders, thereby seriously undermining the value of their shares.[128]

[128] *Ibid* at 5-128.

7 A NEW DISPENSATION

7.1 The new legislative framework

The extensive process of corporate law reform in South Africa has been completed and the new companies Act will come into effect in the near future. Attention will now be given to the approach adopted under the new Act. The new approach will be analysed in two stages. Firstly, the role of solvency and liquidity will be dealt with. Thereafter the case for broadening the scope of protection offered through means of interpretation of the new Act and way in which it interfaces with the Constitution will be examined. Comment will then be made regarding the potential consequences for the development of company law in South Africa.

7.2 The new companies act and solvency and liquidity

The new companies Act builds on and overhauls the solvency and liquidity concept that was introduced into the existing Act by the Companies Amendment Act No. 37 of 1999 in a clear and consistent manner. In as much as it afforded the benefit of working with a blank canvass, the drafting of the new act presented the legislature with a fresh opportunity of thoughtfully and proactively formulating a new framework in line with modern thinking, as opposed to the reactionary means of continual amendment followed over the course of the past thirty-odd years.[129] The legislature has made good use of this opportunity.

Foundationally, the new Act retains the concept of authorised share capital as a protection mechanism for shareholders against dilution.[130] It does away with par value shares, however, (subject to transitional

[129] Department of Trade and Industry, South African company law for the 21st century: guidelines for corporate law reform GG 26493 of 23 June 2004 at para 2.1.
[130] Section 36(1)(a).

provisions), making no par value shares compulsory[131] and does not regulate the way in which subscription proceeds are accounted for i.e. a stated capital account is not required. This makes perfect sense from a creditor's perspective in a dispensation driven by solvency and liquidity, but shareholders are now no longer afforded blanket protection against disparate treatment and will have to look to other means to ensure equality of treatment such as the instruction to directors in section 37(1), pre-emptive rights and the shareholders' appraisal remedy.

The existing act was originally drafted to give expression to the capital maintenance concept and the process of patching it to accommodate a solvency and liquidity approach has resulted in different rules for regulating what in substance amounts to the same fundamental action, being a distribution to shareholders.[132] The existing act does not contain a definition of 'distribution' which hampers it in adopting a uniform approach. This is remedied under the new act. A definition of 'distribution' is contained in section 1 and any distribution is now subject to the solvency and liquidity tests which are centrally contained in section 4, as opposed to being scattered throughout. This is a marked improvement on the existing act which houses the solvency and liquidity tests in section 38(2A) for financial assistance, in section 85(4) for buy-backs, section 90(2) for payments.

The solvency and liquidity tests contained in section 4(1)(a) and 4(1b) respectively. The section requires a consideration of all reasonably foreseeable financial circumstances of the company in respect of both tests. Van der Linde makes the point that while necessary in the context of the liquidity test which necessitates prediction as a matter of course, this requirement is not suitable to the solvency test which is referenced to a

[131] Section 35(2).
[132] Van Der Linde, K 'Regulation of distributions to shareholders in the Companies Act 2008' 2009 *Journal of South African Law* 484 at 484.

specific point in time.[133] The solvency test contains some awkward language requiring consideration of the group perspective as opposed to the company itself and again Van der Linde expresses doubt as to the need for this complication and asks why, if relevant, this requirement is only applied to the solvency test and not the liquidity test.[134] The liquidity test requires a twelve month forecast in line with JSE Securities Exchange listing requirements.[135] For both tests the new Act is more prescriptive than the existing Act, financial information is required to be based on financial reporting standards, with assets and liabilities included at fair valuation. Unless the memorandum of incorporation provides otherwise the preferential rights of preference shareholders must be taken into account when applying the tests. Section 4 includes timing rules that govern the timing of the application of the test to different types of transactions and provides welcome clarity.

Under the exiting Act different distribution had different impacts on the company's capital accounts, but the new Act does not regulate the impact of distributions on the company's capital accounts and does not require the creation of non-distributable reserves.[136] It is also pleasing to see that the solvency and liquidity tests are uniformly applied to all forms of distribution, unlike the existing act in which redemptions and the payment of interest on share capital are handled as exceptions to the capital maintenance rule.

'Distribution' is widely defined in section 1 as a direct or indirect (a) transfer of money or other property from a company to any shareholder of the company or a group company whether, (i) in the form of a dividend, (ii) as a payment in lieu of capitalisation shares, (iii) as consideration for the acquisition by the company of it own shares or for the acquisition of

[133] Van Der Linde, K 'The solvency and liquidity approach in the Companies Act 2008' 2009 *Journal of South African Law* 224 at 227.
[134] *Ibid* at 228.
[135] There are some nuances here. It is not quite this simple. See note Van der Linde *ibid* for more detail.
[136] Van Der Linde *supra* (note 130) at 485.

any other group company's shares by a group company, or (iv) otherwise in respect of any of the shares of a company or a group company, other than pursuant to a dissenting shareholders appraisal remedy; (b) incurrence of a debt or obligation by the company for the benefit of a shareholder of the company or a group company; and (c) forgiveness or waiver by the company of a debt owed to the company by a shareholder of the company or a group company. This definition draws heavily on the best United States and Canadian comparable legislation and is commendably comprehensive, but over-emphasises the group context when 'indirect' arguably already covers this aspect. Van der Linde explains that this over-articulation may lead to absurd consequences in that the downward application of the definition within a group context foreseeable even covers corporate actions in which the basic element of gratuity is absent.[137]

Section 46 applies the section 4 tests to all types of distributions. Furthermore, section 46 requires all distributions to be authorised by the board of directors, except those pursuant to existing obligations or a court order, and the board must by resolution acknowledge that the company will meet the section 4 tests immediately after completing the proposed distribution. What is more, if the distribution is not carried out within 120 business days from the formal acknowledgment, a fresh board resolution must be adopted before the company can carry out the distribution. This clarity on the application of the test is most welcome. Directors liability for those failing to vote against a distribution which they knew was in contravention of the section is contained in subsection 6. This remedies the existing loophole for directors under section 90 of the existing Act which does not address the consequences of a contravention.

[137] *Ibid* at 491.

Section 48 imposes additional safeguard requirements on buybacks over and above the section 46 requirements, given the potential negative impact of this corporate action on shareholders.

Section 44 deals with the provision of financial assistance by the company for the purpose of acquiring its shares. It applies the solvency and liquidity test of section 4 and requires the terms of the assistance to be approved by special resolution. This is similar to the position under the existing act, but a few additional safeguards have been built in. The approving special resolution must designate a specific recipient or a particular category of potential recipient and one only hopes that these additional disclosure requirements will assist in preventing the abuse of power. The board of directors must also be satisfied that the proposed terms are fair and reasonable to the company. While this will be of benefit to creditors, it is doubtful whether this additional requirement is substantively beneficial to minority shareholders. It is the company the terms must be 'fair and reasonable' to and not a shareholder who does not receive such assistance.

It is anticipated that there will be some teething problems with the new Act and indeed certain inconsistencies have already been noted.[138] Presumably these will be remedied before the new Act becomes operational and will soon be left in the past.

This then is how creditors' interests (among others) are catered for under the solvency and liquidity framework of the new Act to ensure the continued viability of the company as an economic unit. But can others, including creditors, find any additional protection under the new Act?

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[138] Refer note 1. Also see Van der Linde *supra* (notes 130 and 131) for detailed analysis of distributions and the solvency and liquidity tests under the new Act.

7.3 Creditors as stakeholders

The shareholder v stakeholder debate has been continuing, if at times somewhat in the background, ever since the Berle-Means seminal work, *The Modern Corporation and Private Property*, sparked discussion around the issue in the United States in the 1930's.[139] It has gained prominence in recent years with many spectacular corporate failures bringing corporate governance under the microscope.

One the one side there are the advocates of shareholders primacy: they claim that it is solely the interest of shareholders that should concern management and that accordingly the only goal of management should be to maximise shareholder wealth. This is the classical Anglo-American position and was famously encapsulated by Friedman when he stated that the only social responsibility of business is to increase its profits while remaining within the rules of the game. Friedman went so far as to label any alternative view as "fundamentally subversive doctrine".[140]

On the other side are those whose insist that the as a separate legal entity the interest of the company cannot simply be those of its shareholders, but that in terms of the implicit social contract that company operate under, other groups interests are also worthy of consideration and protection, and management has a obligation to consider them. Parkinson points out that this view is not necessarily dependent upon any specific formulation of the essence and purpose of the corporate from but is instead based upon a political theory about the conditions under which power, and more specifically corporate power, may be legitimately held and exercised. The nub of such a thesis is that a concentration of power

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[139] In May 1932 Merrick Dodd published the article detailed in note 17 in response to the view of Berle.
[140] Friedman, M 'The social responsibility of a business is to increase its profits' The New York Times Magazine of 13 September 1970.

may only be tolerated if it furthers the public good.[141] Employees' interests are usually singled out as being particularly deserving of consideration.

Adherents to the stakeholder formulation can further be divided into two groups. Firstly there are those that believe that the interest of stakeholders are deserving of attention, but that such interests cannot be pursued as ends in themselves but rather only in so far as they also further the interests of shareholders. This is called the enlightened shareholder value approach. Then, at the extreme, there are those that follow what is referred to a pluralist approach. Pluralists believe that stakeholder interests are worthy of pursuit in their own right, even if such interests conflict with the interests of shareholders.

In the Canadian case of *Teck Corporation v Miller,* [142] referring to the interests of employees, the court held that although it would be improper for directors to entirely disregard to the interests of shareholders, they could not be found to be in breach of their fiduciary duties in they considered the interest of other stakeholders. This remains the leading case in the consideration of stakeholder interests in Canada and is in line with the enlightened shareholder value approach. In the United States too there have decisions in this vein and some states have implemented constituency statues to oblige directors to consider interests other than those of stakeholders.[143]

The United Kingdom followed the enlightened shareholder value approach in its extensive review of company law and chose to include a provision in the statutory listing of directors' duties requiring directors to

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[141] Parkinson, JE *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1993) at 31.

[142] (1972) 33 DLR (3d) 288 313 – 314.

[143] Green, RM 'Shareholders as stakeholders: changing metaphors of corporate governance' (1993) 50 *Washington and Lee Law Review* 1409 at 1411.

have to regard other group's interests when promoting the success of the company for the benefit of its members as a whole.[144]

In our law directors fiduciary duties are currently only found in common law but the new Companies Act contains a provision on the standard of directors' conduct.[145] Although the Department of Trade and Industry favoured the enlightened shareholder value approach, it stopped short of attempting to list the other interests to be considered by directors as was done in the United Kingdom. Instead section 76(3)(b) merely states the familiar exhortation for directors to exercise their duties in the best interests of the company. The scope of directors' duties have therefore not been widened thorough any particular (re)statement of responsibilities.[146] It will still be for the common law to contain and develop the fullness of the meaning and implications of this seemingly simple and familiar sounding provision.[147]

In part 3.2 above creditors' interests were classified as financial both primary and secondary. It is now however contended that the interests of creditors run even deeper than this. 'Creditors' is a compendious term and creditors' interests are therefore diverse. Creditors' interests in the company extend beyond simply having an invoice settled or a debt satisfied and the repetition of that state of affairs. Creditors are also part of society and therefore have an implicit interest in the company fulfilling its societal obligations, if and to the extent that a company can be said to have societal obligations, as much as any other stakeholder does.

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[144] Section 172(1) of the Companies Act 2006.
[145] Section 76 of the new Act.
[146] Rabkin, F 'Directors' duties and human rights' Business Day of 10 November 2008 quotes Cassim's position that this approach is to be preferred over one which conflates constitutional law with corporate law. Directors already have to take into account constitutional requirements and bill of rights. In contrast, Bilchitz favours a specific duty for directors to realise fundamental human rights.
[147] See 7.5 onwards, the traditional Anglo-American view may no longer hold true in South Africa.

While the interests of creditors are traditionally viewed only in the narrow primary financial sense, and to a limited extent in the secondary financial sense,[148] it is worthwhile bearing firmly in mind that because creditors are not an homogenous group and not easily classified, they may well be viewed as having further interests in the company more in line with those of other stakeholders.

7.4 The new companies act and matters of interpretation

Section 5 of the Act is entitled 'general Interpretation' and subsection (1) requires that the new Act be interpreted and applied in a manner that gives effect to the purposes set out in section 7. Section 7 in entitled 'purposes of the Act' and sets out a comprehensive list of the intention of the legislature in promulgating the new Act. Certain of these stated purposes are noteworthy in so far as they potentially widen the scope of directors' fiduciary duties and open the door for the consideration of interests other than those of shareholders:

- Section 7(a) states that a purpose of the Act is to promote compliance with the Bill of Rights as provided for in the Constitution, in the application of company law;
- section 7(b)(iii) states that a purpose of the Act is to develop the South African economy by encouraging high standards of governance in light of '...the significant role of enterprises within the social and economic life of the nation[.]', and
- section 7(d) states that a purpose of the Act is to reaffirm the concept of the company as a means of achieving economic and social benefits.

It is thus the stated purpose of the new Act that its company law should to promote compliance with human rights. The new Act specifically acknowledges that companies have a significant role to play in the social

[148] The liquidity test requires that the company be able to settle its debts for a period of twelve months.

life of the Republic and the attainment of social benefits. Let us now consider the matter of enforcement.

Section 157 is entitled 'extended standing to apply for remedies' and provides that the right to make application to a regulatory institution may be exercised by persons, among others, acting as a member of or in the interest of a group or class of affected persons (subsection (1)(c)) or acting in the public interest, with the leave of the court (subsection (1)(d)). Subsection (3)(a) clarifies that this right is limited to those persons contemplated in section 165(2). Section 165 (2) lists among those persons permitted to take action to protect the legal interests of the company, registered trade unions or other employee representatives (subsection (c)), as well as persons who have been granted leave of the court to protect their legal rights (subsection (c). The result of these provisions is that stakeholders may now be afforded a justicable right of action, or at very least the consideration of a right to action, that is not available under the existing act.[149] But the new Act does not stop there.

Section 158 is entitled 'remedies to promote the purpose of act (sic)':

- section 158(a) requires a court to develop the common law as necessary to improve the realization and enjoyment of rights established by the Act; and
- section 158(b) further requires, among others, a court to promote the spirit, purpose and objects of the Act and where multiple meanings are possible to prefer any interpretation that best promotes the spirit, purpose and objects of the Act.

[149] Coetzee, L 'A comparative analysis of the derivative litigation proceedings under the Companies Act 61 of 1973 and the Companies Act 71 of 2008' 2010 *Acta Juridica* 290 at 298. Coetzee notes that because the new act does not define 'legal interest' or specify the causes of action for which a derivative action can be used, section 165 will be open to very wide interpretation.

Here we find the aspirational language of the constitution being echoed to enjoin the judiciary to adopt of purposive approach to interpretation of company law that necessarily requires the making of value judgments in light of public policy. Sealy states that '...it is rare for a judge in a company law case to make any reference to the policy implications of the ruling he is giving, or even to acknowledge an awareness that that his decision may be helping to shape policy for the future.' [150]This can clearly no longer be true in the South African context.

7.5 The impact of the constitution

The Republic of South Africa has a supreme constitution that is rated amongst the most progressive in the world, with a ground breaking Bill of Rights. Section 8 of the Constitution deals with the application of the Bill of Rights. Section 8(1) is interpreted to provide for the vertical application of the Bill of Rights i.e. between individuals and the state, with section 8(2) making it clear that the Bill of Rights also has horizontal application i.e. between private individuals. Section (3) requires courts to develop the common law to give effect to the Bill of Rights and section 8(4) specifically provides that the Bill of Rights applies to juristic persons.

Not only does all law in South Africa derive its power from the constitution, but structures that are in conflict with the Constitution are not valid.[151] The classical Anglo-American conception of the company as a structure to maximise profits for shareholders to the exclusion of all other rights and interests is therefore no longer tenable under South African law. There is a fundamental difference in the regulatory environment between South Africa and the United Kingdom and United States.[152] The very nature of the company under South African law has

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[150] Sealy *supra* (note 38) at 185.

[151] Bilchitz, D 'Corporate law and the constitution: towards binding human rights responsibilities for corporations' (2008) 125 *SALJ* 754 at 781.

[152] Mongalo, T 'Corporate governance and the constitution: a case for broadening the stakeholders' in Du Plessis, M (ed) *Constitutional Democracy in South Africa 1994 – 2004* 169 at 178.

therefore been altered and has moved away from its Anglo- American origins. [153] The impact of this cannot be over stressed.

There is also a constitutional imperative of interpretation set out in section 39(2) of the Constitution to '... promote the spirit, purport and the object of the Bill of Rights'. Mongalo makes the point in relation to the impact of the constitution in interpreting what constitutes the best interests of the company.[154] He urges courts to be bold in applying constitutional principles and to reflect upon whether the generally accepted and long held interpretations as expressed through the common law remain valid in the post-constitutional environment.

What is most important for us now is the Constitution and not the traditional common law position. Davis et al make the point that in the context of a global neo-liberal agenda in which social rights and entitlements are under attack, it is necessary to '... develop a transformative constitutional discourse that advances the interests associated with social citizenship.'[155] The authors call for a 'transformative constitutional jurisprudence' [156] in light of South Africa's vast and far reaching constitutional transformation and with disappointment note a judicial unwillingness to embrace broad interpretations of social rights.

There can no longer be sheltering in technical legal arguments as under the formalism of the apartheid legal culture.[157] It must be recognised that the core values of the constitution are in contrast to the pre-constitutional

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[153] Bilchitz *supra* at 780-81.
[154] Mongalo *op cit* at 178 – 79.
[155] Davis et al 'Social Rights, Social Citizenship and Transformative Constitutionalism: A Comparative Assessment' in Conaghan, J et al (eds) *Labour Law in an Era of Globalisation: Transformative Practices and Possibilities* 511 at 511.
[156] *Ibid* at 513.
[157] Bilchitz, D 'David Bilchitz: What is reasonable to the court is unfair to the poor' in Business Day of 16 March 2010.

dispensation and status quo.[158] Courts are required to engage in substantive reasoning in the light of public policy and can no longer hold to legal formalism.

7.6 Has the position regarding the protection of creditors interests changed?

The traditional Anglo-American approach to the best interests of the company cannot continue as the dominant view in South Africa given the fundamental shift brought about by our Constitution. The position regarding the protection of all stakeholder interests has changed and therefore by default the position regarding the protection of creditors' interests has changed. Stakeholder interests now have independent value separate and distinct from the interest of shareholders and stakeholders have been given standing to uphold their new rights.

It is often said that a duty to everyone is a duty to no one. Without clear guidance as to what trade-offs between competing interests are both desirable and permissible, management are left to their own initiative in choosing and pursuing corporate goals. Jensen puts this sentiment into economic terms effectively saying that if the corporate objective cannot be expressed as a rational objective function then efficiency can never be achieved.[159] Management becomes its own master. It is interesting to note that when Dodd contended in his famous 1932 article that companies should to be managed in a socially responsible manner, it was with a full understanding that the implication of companies being required to embrace interests beyond those of shareholders would lead to confusion within the ranks of management.[160] His defence was that '[T]he question with which this article is concerned is not whether voluntary acceptance

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[158] Venter, F 'Politics, socio-economic issues and culture in constitutional adjudication' (2003) 6 *Potchefstoom Electronic Law Journal* xiii at xix.
[159] Jensen, MC 'Value maximisation, stakeholder theory, and the corporate objective function' (2002) 12 *Business Ethics Quarterly* 235.
[160] Dodd *supra* (note 17).

of social responsibility by corporate managers is workable, but whether experiments in that direction run counter to fundamental principles of the law of business corporations.' In other words Dodd neatly sidestepped the issue of how competing stakeholder interests should be dealt with.

Courts in South Africa are not going to have the luxury of passing the buck but are going to have to roll up their sleeves and set about creating a framework within which to measure and manage competing stakeholder interests. Either that, or the legislature is going to have to give further guidance to the courts on how to proceed; but it is unlikely that the legislature is going to be drawn on the matter.[161] The legislature has made the bullets but the courts are going to have to fire them; and the bullets may be more closely likened to a bombshell.

It is also interesting to note that while one of the objectives of the process of company law reform was to facilitate compatibility and harmony with international best practice jurisdictions,[162] the overarching effect of our juggernaut Constitution will have implications that run counter to international compatibility.

It remains to be seen how the international business community will respond to these ground breaking developments in South African company law. Although the legislature was conscious not to '...create an uneven playing field to the detriment of South African companies...',[163] it may nevertheless have done so in underestimating the transformative power of the Constitution.

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[161] Rabkin, F *supra* (note 144) quoting Mongalo.
[162] Department of Trade and Industry, South African company Law for the 21st century: guidelines for corporate law reform GG 26493 of 23 June 2004at para 1.2.
[163] *Ibid* at para 3.2.3.

8 CONCLUSION

Even if one views the purpose of company law as being to regulate directors' powers in the best interests of the company, imposing a duty of trust on directors in favour of creditors is inconsistent with the real need for directors to assume calculated risks in the normal course of business and is therefore not tenable. This along with further considerations such as the widely diverse interests of creditors, makes the expansion of directors' duties to include a duty to creditors a dead end as a means of creditor protection. Although the courts have established an ethereal obligation for directors to consider the interests of creditors, their efforts are seriously hampered in instances where the company is not insolvent, and indeed even establishing a framework for determining *de facto* insolvency has in itself been problematic. The exact content of the 'duty' is elusive and even if established, creditors do not traditionally have standing to enforce a remedy. Reactionary insolvency law type provisions are of limited proactive use to creditors and are tantamount to closing the stable door after the horse has bolted. Instead, alternative means have had to be sought to proactively safeguard the economic viability of the company as a building block of the economy, and thereby indirectly address the varied interests of creditors in all their fullness.

The system of legal capital and capital maintenance is a legacy of nineteenth century English jurisprudence. As a scheme it has two driving considerations. On the one hand is the protection of creditor's interest and on the other is the regulation of the relationship between shareholders to achieve equity. This paper has focused on the ability of the legal capital system to address the former consideration as a potential answer to the broader interest of creditors. It was found that capital maintenance is in itself inadequate as measure to achieve the protection of creditors' interests because it is founded on a static and over-simplified view of the company; and it does not address key concerns of creditors which are cash flow based.

Internationally the use of solvency and liquidity tests as a means of protecting the interest of creditors by limiting distributions to shareholders has found favour over the past three decades, first in the United States and then in commonwealth jurisdictions. Solvency and liquidity regimes however are not without their own challenges and the European Union is hesitant to move away from its legal capital system, until there is empirical evidence as to the superiority of one system over the other. Given that solvency and liquidity regimes are still, in relative terms, in their infancy, this approach is not entirely without merit.

South Africa began moving toward a solvency and liquidity regime in 1999 and although the exiting companies Act presents a hybrid approach, being an enigmatic confluence of the old capital maintenance regime and new solvency and liquidity dispensation, the new Companies Act moves boldly into the clear realm of solvency and liquidity as the sole determinative factor limiting distributions to shareholders.

The new Act is not only sympathetic to the interest of stakeholders other than shareholders, it goes so far as to give standing to such stakeholders to call the management of companies (and by implication its shareholders) to account and apply to court for remedies. Because no piece of legislation operates in a vacuum, an analysis of the constitutional framework in which the new Act will operate was required to fully understand to understand the functioning of the new Act in the context of the socio-economic rights guaranteed under the Constitution.

When considering the effect of the new Companies Act and the Constitution in tandem, it seems that the interests of creditors are advanced beyond the economic sustainability achieved, in so far as is possible, by comprehensive solvency and liquidity requirements, in enhanced ways that are yet to become fully apparent. The new act interacts with the Constitution to elevate the interests of other stakeholders, among which are creditors' interests, to a level never before achieved in company law anywhere else in the world. In theory, this puts South Africa in a unique global position. What remains to be seen is if the courts will be willing to depart from traditional legal formalism and embrace the radical transformation demanded of this new order. The new order is not without the significant challenge of having to determine the permissible and desirable trade-offs between competing stakeholder interests, and it is hoped that in the final analysis this does not prove to be an obstacle of such immense proportion that it becomes necessary to throw the baby out with the bathwater.

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